Why Interest Rates Have Been Rising

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W. HAROLD BRENTON, president of the American Bankers Association, recently stated:

"We can't expect some of our citizens to understand the justification for higher interest rates under existing conditions unless they are told the reasons. It then logically follows that bankers should explain to their customers the role of interest rates in a free enterprise economy."

Businessmen and individuals have been finding that borrowing has become less easy and more costly. Some have the impression that either the Federal Reserve System or the banks, or perhaps both, have somehow been "pushing up" interest rates. It is hard for them to see how tighter money contributes to the welfare of the American people.

Actually, the whole cause of sound monetary policy is involved. For although the Federal Reserve System has not been "pushing up" interest rates, the rise in rates does reflect the fact that, for several years, the System has not prevented them from hardening. This policy has helped to halt the erosion that had been taking place for years in the purchasing power of the American dollar. It operates today as a safeguard against renewed inflation.

Explaining the role of interest rates to the public is by no means an easy assignment. A whole new generation has grown up which has never before seen anti-inflationary monetary policy in action. The subject is rather technical and on some aspects the experts disagree.

Nevertheless there is widespread agreement among competent authorities on the broad principles of monetary policy, and these fundamentals can be understood by non-experts. The essential points which should be more widely known and understood, can be summarized as follows:

(1) *Like all other prices, interest rates—the price of credit—are the result of supply and demand forces, except when they are rigidly dictated by government.*

INTEREST rates reflect the relationship between the supply of loanable funds and the demand for them. When demand is large relative to supply, interest rates inevitably tend to rise. When the opposite

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situation prevails, rates decline.

For many years before World War II, for example, the supply of funds was large and, with business in the doldrums, demands for money were small. As a result, interest rates persistently declined to the lowest levels on record.

During the war, the Government's needs for borrowed money were enormous. To facilitate this borrowing and to hold down its cost, the Federal Reserve System, through its open-market operations, maintained a fixed pattern of rates for Treasury borrowing throughout the war.

(2) The fundamental reason for the hardening of interest rates since 1945 is the business boom, which, like all booms, has been accompanied by large demands for credit.

DURING a boom, everybody wants to borrow. The businessman wants to increase his inventory, buy new machinery, expand his plant. The public, fully employed and optimistic, wants to borrow to buy new homes, new cars, new appliances. That, of course, is just what has been happening in this country, on an unprecedented scale, ever since the end of World War II. And the Federal Government, for most of these years has been borrowing too.

This huge demand for credit is the basic reason why interest rates have been rising. Market yields on long-term Treasury bonds turned upward early in 1946, and short-term rates started up in 1947. For several years, the rise was gradual. Banks were eager to make loans and, in addition, the Federal Reserve System, for a variety of reasons, kept pumping out more funds in support of the market for Government securities.

(3) The public welfare normally requires that money should tighten and that interest rates should rise when inflation threatens.

WHEN credit expands at a reasonable rate, it performs a vital function of financing increased production and consumption. It is when credit expands too fast that we get into trouble. When our economy is operating at full capacity, then a big increase in borrowing and spending is bound to bid up prices. Under these circumstances, a substantial increase in credit, even for "productive purposes," turns out to be unproductive and inflationary from the standpoint of the economy as a whole.

The best way to prevent such an overexpansion of credit is simply to permit the increased demands of borrowers to cause some tightening of credit and some hardening of interest rates. This curbs the expansion of credit in two ways: Some potential borrowers are discouraged by the higher cost; others, usually the least creditworthy, are unable to obtain credit accommodation.

The alternative would be inflation and instability. The cost of higher rates is negligible compared with the toll taken from everyone's pocket by inflation. It is infinitesimal measured against the losses of income that occur when an inflationary boom leads to a depression. Sound monetary policy is in the interest of the entire community.

(4) Since the outbreak of the Korean war, the Federal Reserve has permitted credit to tighten in order to combat the threat of inflation.

THE outbreak of the Korean war generated renewed demands for credit. As always, this tended to tighten credit conditions. Bank loans had doubled since the end of World War II, and many banks were beginning to "run out of money." Since Korea, bank loans have increased another 50 percent, so more and more banks have been approaching the position of being "loaned up."

The Federal Reserve System could have kept credit easy if it had decided to pump out all the additional funds required to meet the increased demands. Obviously, however, such a policy would have provided no restraint against excessive credit expansion. The Reserve System has therefore followed a policy of trying to supply enough additional funds to finance increased production but, at the same time, to prevent credit from expanding too fast. In short, it has curbed inflationary pressures by permitting the abnormal demands for borrowing to tighten credit conditions.

Its most dramatic move was in March of 1951 when, with the Treasury's acquiescence, it stopped supporting Government bonds at par. Before that, life insurance companies and other lenders had been able to sell Governments to the Federal at par or better and thereby obtain additional funds to invest in mortgages and new corporate bond issues. This made available a virtually unlimited supply of cheap long-term credit. By stopping its support of Government bonds at par, the Federal Reserve ceased to be an engine of inflation.

(5) Interest rates are still relatively low for this stage of the business cycle.

INTEREST rates today appear high only in comparison with the exceptionally low rates which developed during the long period of depressed business preceding World War II. It was an historical accident that these very low rates happened to prevail at the time of Pearl Harbor and were therefore used as a basis for the low pattern of rates adopted for the Treasury's wartime financing. When we emerged from the war with a vastly swollen public debt, there was a strong desire to keep rates low in spite of their inflationary effects.

This largely explains why rates are still low in comparison with other prosperous periods. Despite more than a decade of almost uninterrupted boom—the biggest in our history—most interest rates are substantially lower than before the Big Depression. For example, as compared with an average rate of more than 5½ percent for the Twenties, lending rates of banks in principal cities averaged 3½ percent during the first quarter of 1953. The Federal Reserve discount rate of 2 percent today compares with 6 and 7 percent in 1920 and a range of 3 to 6 percent for the rest of the Twenties.

(6) The trend of interest rates has been upward throughout most of the free world in recent years.

In virtually every country of the free world, interest rates are now higher than they were before World War II, and considerably higher than in the immediate postwar period. In fact, the rise in long-term rates in the United States has been moderate compared with increases elsewhere. Our long-term rates are well below general world levels.

Compared with the Federal Reserve's discount rate of 2 percent, rates of central banks in the United Kingdom, France, Germany, Netherlands, Belgium, and Sweden range from 3 to 4 percent.

(7) The present level of interest rates does not result in excessive earnings for banks and other lenders.

Some of the proponents of always-easy-money contend that higher interest rates are resulting in "exorbitant profits" for banks and other creditors. This, they say, is a "bare-faced steal" from the pockets of debtors and taxpayers.

It is true, of course, that low interest rates do benefit borrowers but only at the expense of savers and other lenders. For about two decades, borrowers have never had it so good, but savers have never had it so bad. The long period of low interest rates greatly increased the cost of life insurance and private pension plans. It seriously reduced the income of endowments, hospitals, educational institutions, and others.

The real answer, however, is that to the extent that higher interest rates contribute to a stable economy and a stable dollar, they are beneficial to all groups—and particularly to the taxpayers who must pay for a vast rearmament program.

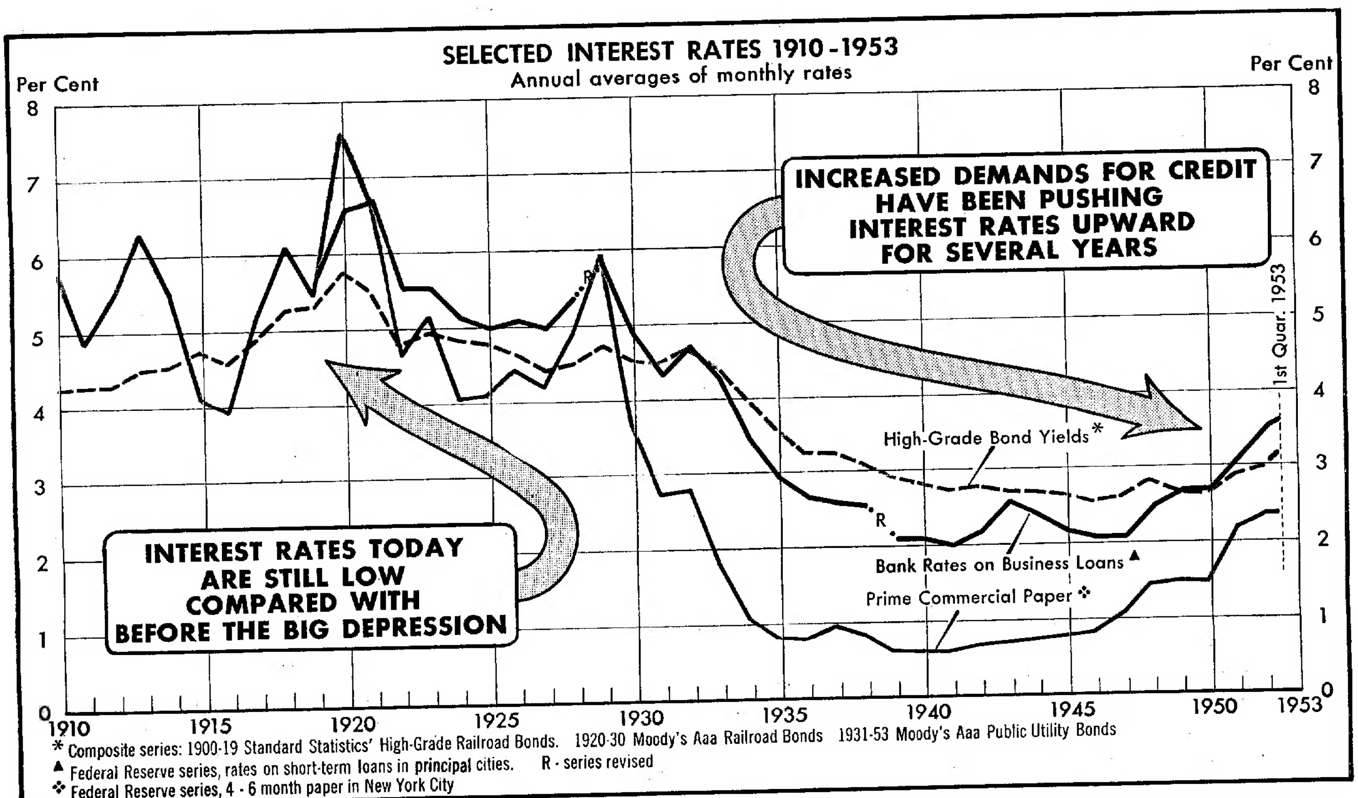
As for the banks, tighter money is by no means an unmixed blessing. It has restricted the growth of their loans and investments and has caused substantial losses and depreciation in their bond portfolios. Higher interest rates have induced many corporations to draw down their bank balances to invest in short-term Government securities. Finally, part of the Federal Reserve's restrictive program was a boost in bank reserve requirements in 1951 and this deprived the banks of the use of about \$2-billion of their assets.

At this stage of the business cycle, with loans at record levels, the banks ought to be showing really good earnings. Last year net profits of all member banks averaged less than 8 percent of total capital accounts, and dividends amounted to only 3.7 percent. If this is the best the banks can do at such a time, what will their position be when the abnormal demands for credit subside and interest rates again decline?

This situation is reflected in the fact that most bank stocks are quoted at less than their book values. The verdict of the investment market is that bank earnings are not too satisfactory.

(8) The existence of market depreciation in bank bond accounts is no reason for objecting to the principle that interest rates should be permitted to rise.

There are many bank directors—and probably some bankers—who do not understand, and are unhappy



about, the depreciation in their banks' bond portfolios.

The fact is, of course, that rising interest rates mean declining bond prices—they are, indeed, synonymous. The market yields of Government securities are the basic interest rates which affect the level of all other rates. When these market rates of interest on Government obligations are low, all other rates tend to be low. When they rise, all other rates tend to rise.

It would be nice, from the standpoint of lenders, to have both high money rates and high bond prices, but that is literally impossible. We simply cannot have it both ways.

One consolation about lower bond prices is that new investments can now be made at higher rates than formerly. Another, for most banks, is that bond depreciation is largely academic because most of those book losses will never have to become real losses. The average bank will probably achieve somewhat better earnings in 1953 than last year or the year before, and it is these actual results, after all, that really matter. Finally, some banks can use bond losses to good advantage for tax purposes.

But the real answer is that it is essential to the health of a free enterprise economy that interest rates should be flexible. That means bond prices will decline under certain conditions as well as rise under others. Moreover, it is not the banker's job to try to outguess the bond market. These fundamental facts about the banking business should be understood by every bank director.

(9) *Discussion of the Treasury's recent offering of long-term bonds has greatly exaggerated its actual importance.*

THE dramatic and controversial aspects of the Treasury's recent bond issue have attracted much attention. The chief significance of the offering is that it indicated a change from the policy of the past seven years. It also unsettled the bond market.

Viewed in perspective, however, the offering of $1-billion of long-term Treasury bonds at 3¼ percent is, in itself, something less than epochal. It will be recalled, for example, that during the 13 years preceding 1946, the Treasury was continually bringing out new long-term bond issues—far more, in fact, than had previously been issued in our entire history. Taking taxability and tax rates into account, many of those offerings involved a higher net cost to the Treasury than the new 3¼s. Moreover, most of them were made when the difference in cost between short-term and long-term financing was considerably greater that it is today.

The size of the new issue is, of course, small. It is about one-tenth as large as the last offering of marketable long-term bonds under the Truman Administration. It represents less than 2 percent of the Treasury's obligations due this year. It is about half of 1 percent of the total debt.

Its main effect upon the economy is that it has absorbed some savings which otherwise would have gone into capital expenditures. But with private investment now at a $54-billion annual rate and with gross national product exceeding $360-billion, a Treasury bond offering of $1-billion does not look very significant.

(10) *It is the overwhelming informed consensus that the Federal Reserve has been right in its general policy of permitting credit conditions to tighten.*

MANY economists would word this proposition even more emphatically. In fact, most would probably agree with the recent assertion of Chairman Martin of the Federal Reserve Board that the stability of the American economy over the past two years would not have been achieved without the contribution made by Federal Reserve policy.

There is some disagreement among the experts, naturally, with respect to certain of the Federal Reserve's actions. Judgments are always bound to differ as to exactly how an agreed-upon principle should be applied under various circumstances. However, the main point is that there is almost complete unanimity among competent authorities on the broad proposition that a monetary policy of moderate restraint has been in the national interest.

The soundness of this policy is transparently clear when one considers the alternative. To keep credit easy during such a period would be to invite over-expansion and over-speculation, and thereby sow the seeds for a depression.

It would be a public misfortune if monetary policy were to become a political football. Nor would it make sense either logically or historically. The principle of flexibility of interest rates has repeatedly received bipartisan endorsement by the Joint Committee on the Economic Report. The present policy of credit restraint was initiated under a Democratic administration and has been developed under three Reserve Board chairmen who were appointed by Democratic presidents. It has not been basically altered by the shift to a Republican administration.

Conclusion

What of the future? As long as the boom continues, the Federal Reserve intends to adhere to a restrictive policy. This could easily mean some further tightening of credit.

The *degree* of restraint that is appropriate as conditions change is obviously an extremely complex problem which the Federal Reserve authorities are constantly studying. The degree of restriction to date has been moderate. If desired, pressure could easily be increased. On the other hand, past experience has demonstrated that there are serious dangers involved in putting on the credit brakes too hard.

When the current boom subsides, private demands for credit will slacken and credit will therefore tend to ease. When that happens, it is to be expected that the Federal Reserve will promptly reverse its policy and permit rates to decline. Over the years, this alternative easing and tightening of credit can make an important contribution to the stability of our economy.

In a democracy such as ours, sound monetary policy cannot survive and be truly effective without the support of the public, and this, in turn, requires understanding. Bankers have a public obligation, as well as a duty to their own institutions, to do what they can to contribute to that understanding.